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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

National Cable Television Association

Legal Department

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September 15, 1993

DOCKET FILE COPY ORIGINAL

Mr. William Caton
Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, DC 20554

Re: MM Docket No. 93-215; Erratum

Dear Mr. Caton:

The National Cable Television Association filed yesterday its Reply Comments in the above-captioned proceeding. It has come to our attention that due to a copying error, the last page of the attachment was missing from the duplicate copies filed. Accordingly, NCTA hereby submits for filing an original and nine copies of the complete set of its Reply Comments.

If you have any questions, please contact me.

Respectfully submitted,

Diane B. Burstein

Diane B. Burstein

Enclosures

DBB:ldh

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

REPLY COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION

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September 14, 1993

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REPLY COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION

The National Cable Television Association ("NCTA"), by its attorneys, hereby submits its reply comments in the above-captioned proceeding.

INTRODUCTION AND SUMMARY

The comments submitted in this proceeding demonstrate the critical importance of adopting cost-of-service standards that are tailored to the cable industry. These rules must properly balance the interests of cable operators and cable subscribers. They also must ensure that future system improvements are not brought to a standstill. And they must take into account the unique circumstances arising from cable television's transition from an unregulated to regulated environment.

In our initial comments, NCTA urged that the Commission adopt a flexible approach that allowed operators to fully justify their costs in seeking to demonstrate the reasonableness of their rates. Several commenters instead propose stringent and inflexible rules that would unreasonably deny cable operators the ability to recover their costs and would make wholly illusory the cost-of-service "backstop" to the benchmark rates. For example, the cities propose procedural roadblocks and substantive standards that would unlawfully prohibit operators from recovering reasonable costs. The telephone companies claim that "regulatory parity" should be the Commission's guiding principle and advocate foisting on cable inappropriate rules that were developed in the telephone context. Either of these approaches would ill-serve consumers, and would deny cable operators the opportunity to recover a reasonable return on their investment.

As part of their proposals, these commenters also suggest that the Commission shrink an operator's allowable rate base by adhering to "original cost" valuation, and adopt an unreasonably low rate of return. However, use of a seller's original cost in establishing the rate base is simply the wrong starting point and the advocates of original cost rest their arguments on unsupported and unsupportable assumptions about why acquisition prices exceed the seller's cost to construct a cable system. Moreover, given that investments in cable television are viewed as riskier than those in telephone companies, the rate of return should reflect that significantly higher level of risk.

I. Goals of the Cost-of-Service Proceeding

Two themes emerge from a review of the comments filed in this proceeding by representatives of certain municipalities and by certain telephone companies. First, according to the cities,[1] the cost-of-service procedures and standards should result in rates no higher than the benchmark rates, even if that means preventing the recovery of reasonable costs, depriving investors of a reasonable return on their investments, hindering future investments or denying customers new and improved service. Second, certain telephone companies urge that the regulatory standards applied to cable operators should precisely parallel those employed in telephone regulation. These propositions are

[1] See Comments of the National Association of Telecommunications Officers and Advisors, the National League of Cities, the United States Conference of Mayors, and the National Association of Counties (hereinafter "NATOA"); Comments of Austin, Texas; King County, Washington; and Montgomery County, Maryland (hereinafter "Austin, Texas et al."); Comments of Municipal Franchising Authorities (hereinafter "MFA").

flatly contradicted by the Cable Act itself and they should not form the basis of the cost-of-service rules adopted by the Commission.

A. The Commission Should Reject the Cities' Efforts to Prohibit Cable Operators From Recovering Costs Plus a Reasonable Profit

The Cable Act directs the FCC to adopt rules designed to ensure that where competition is lacking, basic rates are "reasonable," and cable programming service rates "not unreasonable." Congress did not require -- and, indeed, would be constitutionally prohibited from requiring -- that rates be lowered regardless of whether reduced rates would allow recovery of costs plus a reasonable profit. To the contrary, the Act specifically directs the Commission, with respect to basic service rates, to take these factors into account.[2]

Certain commenters, however, propose cost-of-service tests that demonstrate a desire to deny operators recovery of legitimate costs. The MFA urges that "rates should approach not what the operators' costs are, but what they might be if they were lean, competitive companies."[3] NATOA urges that cable operators be prohibited from recovering certain joint costs from subscribers to regulated services.[4] Austin, Texas et al. suggest that "[a] cable company will not be allowed to inflate the investment attributable to basic and expanded basic cable service and equipment when it upgrades the system unless, for example, it can also show that the rebuild substantially benefited subscribers to the regulated services and that costs allocated to those subscribers do not exceed the

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2 Act, Section 623(b)(2)(C).

3 MFA at 8.

4 NATOA at 10-11 (arguing that "extraordinary" costs must benefit all subscribers in order to be recoverable in cost-of-service showings).

cost of alternatives."[5] These suggested tests would both lead to a deterioration of existing service to all subscribers and would bring future system advancements to a halt.[6]

These suggestions are classic illustrations of the potential imbalance to be guarded against in rate regulation. The function of the regulatory authority is to set rates which properly balance the competing interests of ratepayers and investors. Representatives of ratepayer interests who succumb to a narrow view of consumer concerns may press for any principle or concept which reduces the price paid for service. Thus, they perceive no problem in proposing non-recovery of legitimately incurred costs of providing service. However, sound regulatory policy must also take account of the need to maintain the financial integrity of the regulated firm. Without such integrity, the investors in that entity will be denied the protection from taking of their investment called for by the Constitution. Of equal importance, the consumer interest will ultimately not be well-served if financial integrity is impaired and the ability of the regulated entity to maintain or improve service quality is thereby threatened.

Congress was well aware of these concerns in passing the Cable Act. It clearly stated its policy to "ensure that cable operators continue to expand, where economically

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[5] Comments of Austin, Texas at 10.

[6] The Commission in its Rate Regulation Reconsideration has denied operators the ability to automatically pass through costs of voluntary system upgrades and rebuilds. Operators instead will be forced to rely on cost-of-service proceedings to justify rate increases resulting from rebuild costs. The Commission in its Third Further Notice of Proposed Rulemaking is seeking comment on whether franchise-required rebuilds and upgrades may be automatically passed through to subscribers. We intend to fully address this issue in comments to be filed on this question. Nevertheless, if cost-of-service will be the only way to justify these system improvements, the Commission must adopt a streamlined cost-of-service showing and must also strictly circumscribe local authorities' ability to second guess the costs incurred for voluntary upgrades and rebuilds.

justified, their capacity and the programs offered over their cable systems."[7] As the Notice in this proceeding properly recognizes, the Commission's "requirements should not thwart operators' ability to respond to competitive forces by means of facility and service improvements."[8] For this reason, the FCC "tentatively concludes that our regulatory requirements for cost-based rates should also be designed to assure that cable operators may fully respond to incentives to provide a modern communications infrastructure and to respond to competitive forces."[9] The Commission should adhere to this goal, and should vigorously resist the efforts of the cities to thwart cable television's ability to provide subscribers with the improvements they desire.

The Commission should similarly reject the cities' efforts to place virtually insurmountable obstacles to making a cost of service showing in order to force reliance on the benchmark rate process. NATOA, for example, proposes to allow operators to invoke cost-of-service showings only in "extreme cases"[10]: an operator would be required to show that its rates are "necessitated by extraordinarily high and justifiable costs" measured by comparison to other "similarly-situated systems", and it must show that the recoverable costs are for "expenses that benefit all subscribers."[11] MFA goes so far as to pronounce that "current rates set by the cable companies are clearly excessive"[12]

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7 Act, § (b)(3).

8 Notice, ¶ 9.

9 Id.

10 NATOA at 7.

11 Id. at 8.

12 MFA at 13.

and suggests "limit[ing] cost-of-service showings as to initial regulated rates to 'special circumstances of extraordinary costs'".[13]

The Commission has previously acknowledged that the ability to justify rates through a cost of service showing is a necessary adjunct to its benchmark approach.[14] Because the benchmark rates have no direct relationship to costs of providing service, and are flawed in many respects, it cannot be presumed that rates in excess of the benchmarks are not reasonable. The Commission currently has no information regarding the typical cost of providing cable service. Under these circumstances, it would be highly arbitrary, and contrary to constitutional principles as well, to place these high hurdles before a cost-of-service showing could be made.[15]

As even MFA understands, the way to limit cost-of-service filings and to encourage reliance on the benchmark is to fix the flaws in the benchmark approach.[16]

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[13] Id. at 5.

[14] See Memorandum Opinion and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266 (rel. Aug. 10, 1993) at ¶15 ("To the extent that the Commission's primary method of competitive benchmarks and price caps may be inadequate when applied in individual circumstances, the Commission has given assurance that it will permit cable operators an opportunity to demonstrate the reasonableness of higher rates based on costs and to charge existing higher rates based on these costs until a ruling is made on its cost demonstration.")

[15] We also disagree with the arguments advanced by the cities that an operator should be prohibited from justifying rates based on a cost-of-service showing for one regulated tier if it relies on the benchmark methodology to justify rates on a different regulated tier of service. This issue has been directly raised in the Commission's Third Further Notice of Proposed Rulemaking. NCTA intends to fully address this issue in comments to be filed in that proceeding.

[16] See, e.g., MFA at 5 (in order to ensure that more operators rely on the benchmarks instead of cost-of-service proceedings, the Commission should "direct its efforts at refining [the benchmark] approach to better address some of the concerns of the cable industry").

But the Commission cannot erect the artificial barriers to cost-of-service showings that the cities propose.[17]

B. Regulatory Parity, As Conceived By Telcos, Is Not The Answer

Comments submitted jointly by Bell Atlantic, NYNEX and the Pacific Companies ("Bell Atlantic") assert that "regulatory parity," should be "the Commission's guiding principle in this proceeding. . ."[18] But even the most cursory review of their proposal makes clear that, rather than seeking "regulatory parity", Bell Atlantic's real goal is regulatory advantage.

Congress has adopted different schemes for regulating cable television and telephony. If Congress had wanted "regulatory parity," it would have declared cable television a common carrier subject to Title II of the Communications Act, and anticipated, pursuant to Section 2(b), 47 U.S.C. § 152(b), that states would regulate cable as they regulate telephone companies. Instead, Congress adopted the 1992 Cable Act (the "Act"), which authorizes very different mechanisms for rate regulating cable.[19] Rather

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[17] The Commission also should not adopt the proposal to preclude operators whose pre-regulation rates are below the benchmark from making a cost-of-service showing. See Comments of Utah League of Cities and Towns at 6. There is no reason why these operators should be penalized by denying them recovery of legitimate costs plus a reasonable profit. Given the Commission's treatment of these operators under the benchmark scheme -- in which they are precluded from raising their rates to the benchmark -- cost-of-service may be their only means of recovering costs.

[18] Joint Comments of Bell Atlantic, the NYNEX Telephone Companies and the Pacific Companies at 1 (hereinafter "Bell Atlantic")

[19] Congress also retained section 621(c) of the 1984 Act, which explicitly provides that "[a]ny cable system shall not be subject to regulation as a common carrier or utility by reason of providing any cable service."

than granting cable systems "artificial regulatory advantages"[20] over telephone companies, it imposes in many respects a much more burdensome regulatory scheme.

For example, telephone terminal equipment was deregulated years ago, while cable's terminal equipment is regulated at actual cost. Cable services, except for pay-per-view and per channel services, are rate regulated, but telco enhanced services operate free of regulation. Telephone service is potentially subject to rate regulation by the FCC and the states. Cable service is subject to regulation by the FCC and, potentially, by tens of thousands of local communities. Telephone rates must be reviewed by regulators only when the regulators decide they ought to be reviewed. Cable program service rates must be reviewed by the FCC if a state, franchising authority, local government or any of the nation's 58,000,000 cable subscribers complain that rates are unreasonable. While Bell Atlantic has a monopoly on telephone service, it has no monopoly on overly burdensome regulation.

In addition to these burdens, Bell Atlantic asks the Commission to apply to cable cost-of-service ". . . rules that currently apply to telephone companies [that] are outmoded and should be streamlined or eliminated."[21] While we believe the cable regulatory scheme is seriously flawed, applying telephone regulation as the "guiding principle in this proceeding" is not the answer.

II. Original Cost is the Wrong Starting Point For Establishing the Rate Base

NCTA's initial comments, as well as the comments of the numerous cable operators filing in this proceeding, demonstrate the critical importance of properly tailoring cost-of-service rules to meet the economic and financial requirements of the

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20 Bell Atlantic at 1.

21 Bell Atlantic at 2. We disagree, generally, that these Title II regulations are outmoded and should be eliminated.

cable industry. A cost-of-service mechanism is needed that enables operators to fully justify their costs of providing cable service and does not arbitrarily exclude certain costs -- especially costs above the original cost to construct a cable system -- from the rate base.

As we described in our comments, in initially valuing cable plant in service, the original cost of a cable system is simply the wrong starting point. There is no rational relationship between original cost and the cost of providing cable service. An original cost approach would penalize cable systems purchased in arms' length transactions after the fact, and would fail to properly recognize start-up losses and foregone revenues in cable systems constructed and still held by their original owner.[22] These views were reinforced by the numerous cable commenters in this proceeding, who have amply demonstrated that disallowance of intangible costs would gravely disrupt the capital and financial structure of the industry and run afoul of constitutional principles.[23]

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22 See generally Comments of Continental Cablevision, Inc. at 18-21 (describing start-up losses and deferred returns in a typical "build and hold" system); Comments of Time Warner Entertainment Company, L.P. at 32-33 and attachment at 21.

23 E.g., Comments of Cablevision System Corp. at 18; Comments of Continental Cablevision, Inc. at 26; Comments of TCI at 17-25; Comments of Tele-Media Corp. at 14.

CFA argues that the Constitution protects only against "financial bankruptcy of the system", and proposes that "recovery of excess acquisition costs should be allowed only for the purpose of avoiding bankruptcy. . ." CFA at 4. But that is not the proper constitutional test. As the D.C. Circuit described in Jersey Central Power & Light Co. v. FERC, "Hope Natural Gas talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity." 810 F.2d 1168, 1180 (D.C. Cir. 1987). The Commission, moreover, has specifically rejected the notion that rates can exceed the benchmark only where benchmark rates would be "confiscatory": the cost-of-service standards are to "[e]mbody . . . a balancing of the interests of consumers in paying a reasonable rate and of cable operators in earning a reasonable profit. A 'confiscatory only' standard would, by contrast, constitute a substantially stricter standard that may ultimately disserve consumers by limiting cable operators' business incentives to

(Footnote cont'd)

The advocates of original cost primarily rest their arguments on erroneous assumptions regarding why purchase prices exceed the seller's cost to construct a cable system. In essence, these commenters claim that any part of the purchase price attributable to intangibles reflects nothing more than an expectation of monopoly profits. These bald statements are unsupported, unsupportable and conflict with the treatment of acquisition costs in other industries with much higher penetration than cable television. As NCTA's initial comments described, fully competitive businesses sell at prices that far exceed their original cost.[24] The fact that cable acquisition prices may have exceeded the original cost to the seller constructing the system is, therefore, hardly surprising -- and demonstrates nothing about monopoly profits.[25]

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provide service." Report and Order, MM Docket No. 92-266 (rel. May 3, 1993) at ¶ 263; cited in NCTA's Comments in MM Docket No. 93-215 at 4.

[24] See also Comments of Continental Cablevision, Inc. at 36-39 (describing acquisition prices of communications companies for 1985-90, all of which significantly exceeded book value of the company acquired); Comments of Viacom International at 32-33 (describing how "in growing industries, competitive markets will value assets well above historical costs -- indeed, even well above replacement costs").

[25] It is interesting to note that Bell Atlantic veers from its devotion to "regulatory parity" when it comes to issues of original cost. It argues that not only should excess acquisition costs be excluded, but that they should also not be amortizable as an annual expense. Bell Atlantic at 23. Such an approach would be much more stringent than that allowed certain telcos. As described in our initial comments, the Commission has applied its rules regarding acquisition adjustments for certain local exchange carriers prospectively, and grandfathered existing acquisition adjustments within the rate base as a transitional mechanism. LEC Rate Base, 4 FCC Rcd. 1697, 1705 (1989), cited in NCTA's initial comments at 14.

But in any event, the reasons for applying original cost to telephone companies have no applicability here. While an original cost rate base may make sense for a utility that has been subject to regulation virtually since its inception, it makes no sense for an industry facing regulation for the first time. As described in our comments, original cost rate base was adopted in the regulated utility arena in order to prevent utilities from trading properties at inflated levels, thereby expanding the rate base

(Footnote cont'd)

As many of the cable industry comments explain, the premium paid above the seller's original cost reflects a wide variety of factors. These include the seller's recapture of start-up losses and unrecovered depreciation and interest expenses, subscriber lists, technical expertise, economies of scale and other efficiencies that improve service and lower cost.[26]

It is not the case, as NATOA suggests, that "excess" acquisition costs should be excluded from the rate base because consumers allegedly enjoy no benefit from these acquisitions. Acquisitions may improve service in many cases, allowing clustering of facilities, improved signal quality, increased channel capacity, upgraded customer service capabilities and more diverse service offerings. But their comments are particularly ironic insofar as the cities in many cases approved these transfers.[27] As the New York State Commission on Cable Television's comments recognize, "many [cable system] transfers were subject to government consents (and . . . to substantive requirements for systems modernization) and the inflated prices [in the latter part of the 1980's] were not unique to the cable television industry."[28] The Massachusetts Cable Commission

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upon which a return is earned and demanding higher rates -- a situation demonstrably not the case here. For these reasons, should the Commission adopt an "original cost" valuation for cable, those assets should be valued at their market value at the time they are "devoted to public service" -- that is when they came under rate regulation. See NCTA Comments at 12-13.

26 E.g., Comments of Cablevision Systems Corp. at 19-20; Comments of Comcast Cable Communications, Inc. at 30-35 (describing value of intangible assets).

27 See Comments of Cablevision Systems Corp. at 13 n.22.

28 New York State Commission on Cable Television Comments at 6. NYSCC, however, proposes that excess acquisition costs could be included in the rate base based on demonstrable need, or amortized over a period, perhaps shorter than 40 years. Id.

similarly explains "while high debt costs have been an ongoing concern of this office, we find it difficult to equitably remedy this situation given that past acquisition behavior was within then-current transfer regulations."[29] It thus "[m]aintain[s] deep reservations about the fairness of disallowing any lawful acquisition costs that were incurred by the cable operator prior to passage of the 1992 Act,"[30] and recommends regulations that would exclude from the rate base only future "excess" acquisition costs.

Nothing has been presented in the record that demonstrates that any portion -- and certainly not the entirety -- of acquisition costs constitutes a monopoly rent component if one were to exist. It would be entirely arbitrary, therefore, for the Commission to flatly exclude all acquisition costs in excess of the seller's original cost from the rate base. The Commission can presume that all costs arising from acquisitions prior to the Cable Act are per se legitimate and not incurred to fatten a then-nonexistent rate base. There was no basis to anticipate any benefit in doing so, and every marketplace impulse by the acquiring operator to keep the purchase price low.

In individual cases, a complaining party or franchising authority could seek to demonstrate that a monopoly rent component exists in the rate charged to subscribers and therefore a portion of costs should be disallowed on this basis. In such cases -- and we do not conclude that such factors inhere in all acquisition costs -- a challenger could look to competitive systems as a guide. Viacom International and Cablevision Industries have noted in their comments there are methods of measuring the "competitive market value" of a system that would exclude a monopoly rent component, if one were to exist. These

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[29] Massachusetts Cable Television Commission Comments at 7.

[30] Id. at 7.

approaches would be far more valid than arbitrarily excluding "excess" acquisition costs from the rate base.

It is in the interest of consumers that cable television infrastructure investments continue to take place at an economically efficient level. This can happen only if investors expect to earn an adequate rate of return on their investments in cable. Capital market expectations will be affected by the approach to rate base valuation taken by this Commission. Original cost valuations clearly understate cable system economic market values, whether or not market value includes a "monopoly rent" or related premium. Adoption of an original cost rule by the Commission will reduce investor expectations regarding future returns, and therefore restrict the supply of investment capital. Only an approach based on market value (adjusted for the effects of competition, if any) can result in economically efficient investor expectations.

The use of market value to establish rate bases, whether or not adjusted to exclude possible monopoly rents, is feasible in the cable industry. In the attached paper, Economists Incorporated describes methods to establish competitive market values based on the sales prices or cash flows of competitive systems or of regulated systems charging competitive benchmark rates. In a paper attached to the Comments of Viacom, the Brattle Group describes a method that relies on event studies.

III. Any Rate of Return Must Reflect the Higher Risks Associated With Cable Systems

In our initial comments, NCTA demonstrated that the risks associated with cable systems differed significantly from, and in general exceeded, the risks attendant to telephone companies or the S&P 400. Any rate of return adopted by the Commission must take this increased risk into account, and a higher rate of return is accordingly warranted.

The assumption reflected in several comments[31] that cable television is no more risky than telephone companies is simply not based in reality. But the argument advanced by Bell Atlantic -- that cable is even less risky than telephone companies -- is absurd.

Bell Atlantic attaches an affidavit purportedly supporting this statement based on a single quotation from a single investment service.[32] Their economist claims that "while the overwhelming majority of cable operators still face no multichannel competition in the local markets, telephone companies face rapidly increasing competition for their most profitable business. . ."[33]

This statement ignores reality. Cable companies provide a discretionary service; telephone companies an essential service. Cable companies are likely to be more sensitive to fluctuations in the economy than telephone companies. And while it may be true that local telephone companies to a highly limited and incipient extent face competition, cable competes on a much broader scale. The vast majority of cable subscribers can receive at least three broadcast stations. Cable also competes with MMDS, SMATVs, home satellite dishes, and faces very real prospects of potential competition with direct broadcast satellite and, perhaps, even telephone companies. The cable industry as a result certainly faces greater business risks than telephone companies, or most industrial firms.

The inherent riskiness of cable from an investor perspective has been amply explained in the comments in this proceeding. As we showed, data from the investment markets indicate that cable companies are more risky than telephone companies or the

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[31] See, e.g., Comments of Austin, Texas at 13; Comments of GTE at 28.

[32] See Bell Atlantic, Vander Weide affidavit at 11.

[33] Id. at 12.

S&P 400 and therefore their cost of equity can be expected to be higher. Furthermore, investors view bonds of cable companies as much more risky than bonds of telephone companies, whose ratings range from Aaa, "best quality", to A, "upper medium-grade obligations."[34] The lowest rated telephone company is rated above the highest rated cable company -- which range from Baa, "medium grade obligations" to B, lacking "[c]haracteristics of the desirable investment. Assurance of interest and principal payments . . . over any long period of time may be small."[35] And while major telephone company stocks all pay dividends, cable company stocks generally do not.

In short, there is every reason to believe that the rate of return for cable must be significantly higher than for telcos on account of the higher risks associated with cable investments.

IV. All Taxes Should Be Recovered in Cost-of-Service Proceedings

The Comments of Austin, Texas, et al., suggest the untenable proposition that the Commission should consider denying recognition of income tax expense in setting cable rates.[36] On several grounds, this suggestion should be summarily rejected. First, it is directly contrary to the fundamental principle that rates established on a cost-of-service basis should provide for recovery of all reasonable costs of doing business and provide the opportunity for a reasonable return. Payment of taxes on the income produced by providing cable service is clearly a reasonable, indeed unavoidable, cost of doing business. A return which did not take account of that tax obligation would be per se unreasonable. Second, the approach suggested by Austin, Texas, et al., flies in the

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[34] Descriptions are from Moody's Investors Service, "Moody's Bond Record, U.S. Corporate Bonds Ratings", August 1993 at 3.

[35] Id.

[36] Austin, Texas et al. at 3-4.

face of long-established U.S. Supreme Court precedent recognizing income taxes as a recoverable expense.[37] Third, the rationale proffered by Austin, Texas, et al.,[38] is unconvincing. They suggest only the possibility that an incorrect amount of income tax expense might somehow creep into the cost-of-service determination. Regulatory commissions have dealt with the proper calculation of allowable income tax expense for many years and this Commission is fully capable of establishing the proper methodology for inclusion of income taxes in the cost-of-service.

As we described in our initial comments, the Commission's cost-of-service standards must assure recovery of all reasonable expenses incurred in providing cable service, including recovery of income taxes. Income tax recovery must be provided for equitably without regard to the form of business organization chosen by the cable operator, particularly where that form of organization was chosen in the absence of a rate regulation requirement. It defies logic to suggest that a business entity organized as a Subchapter S corporation, a partnership or a sole proprietorship somehow has avoided the creation of an income tax obligation arising from carrying on its business. Obviously, businesses employing these other organizational forms create an obligation to pay taxes on the income produced by their business activities. The only characteristic that distinguishes them from Chapter C corporations with regard to taxation is the mechanics by which the tax is collected. If businesses could truly avoid the cost of income taxes attributable to their activities by that simple choice of organizational form, there would be a virtual stampede away from Chapter C corporate form.

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37 Galveston Electric Co. v. City of Galveston, 258 U.S. 388, 399 (1921); see also Fed. Power Comm. v. United Gas Pipe Line Co., 386 U.S. 237, 243 (1967) ("Normally included as a cost-of-service is a proper allowance for taxes, including federal income taxes.")

38 Austin, Texas et al. at 4.

As pointed out in NCTA's initial comments, Congress framed the provisions of Subchapter S to avoid the possibility that the choice of business form would be controlled by tax considerations, not business concerns. If the Commission's rate setting standards deny recognition of income tax expense on the basis of a wholly unrealistic premise that cable operators organized in certain forms (Subchapter S, partnerships, sole proprietorships) have somehow avoided an income tax obligation attributable to providing cable service, it will frustrate Congressional intent on tax policy, and force affected cable operators to make an unnecessary choice between a preferred form of organization or recovery of the income tax liability which is undeniably created by their business activities in providing cable service.

V. The Commission Should Permit Flexibility in Allocating Costs

In our initial comments in this proceeding, we argued that cable operators should have broad flexibility in allocating costs. There is no basis at this point upon which the Commission can establish detailed cost allocation rules.[39] As we said in our comments, one possibility on an interim basis would be to allow cable operators to follow the rules set out in the Report and Order for cost allocation. Operators should also be able to demonstrate that different costing approaches are appropriate.[40]

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[39] See Comments of TCI at 55-56 (describing process of devising cost allocation rules for telcos); Comments of Time Warner Entertainment Company, L.P. at 38-39.

[40] See, e.g., Comments of Continental Cablevision, Inc. at 80-81 (describing difficulties inherent in inflexible accounting and allocation rules); Comments of Cablevision Systems Corp. at 36-38 (describing problems with tier-neutral approach to allocating costs); Comments of Time Warner Entertainment Company, L.P. at 13-14 and attachment at 16-20 (describing difficulties and distortions caused by non-economic allocation process); Comments of Cable TV of Georgia Limited Partnership et al. (arguing that FCC should not adopt single method for allocating costs); Comments of the Medium-Sized Operators Group at 25-28 (arguing for flexibility at initial stage of regulation).

Bell Atlantic glibly proposes that the same telco accounting, cost-allocation, and affiliate transaction rules should be applied to cable television.[41] This superficial call for regulatory parity is entirely inappropriate in this case. It would be neither "efficient" nor "simple", as Bell Atlantic alleges,[42] but wholly arbitrary and capricious, and contrary to congressional intent.[43]

It has taken decades for the Commission to develop cost accounting and cost allocation rules for telephone companies. The Commission simply cannot be expected to accomplish this task in the short time necessary to resolve this proceeding.

The Austin, Texas et al. comments raise a red herring in asking the Commission to "carefully circumscribe the ability of operators to include parent company costs in rates."[44] Contrary to their suggestion, it is completely appropriate to allocate certain parent company costs to a local franchise area. Merely because these costs arise at a different level in the corporate structure does not taint these costs -- or warrant automatic disallowance, as Austin, Texas, et al. seems to propose.[45] Rather, the pertinent questions are whether the cost, at whatever level incurred, is reasonable and whether the portion allocated to a particular service is appropriate.

VI. There is No Reason to Adopt a Productivity Offset

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[41] Bell Atlantic at 14.

[42] Id.

[43] Congress specifically instructed the Commission to "avoid creating a cable equivalent of a common carrier 'cost allocation manual.'" H.R. Rep. No. 102-628, 102d Cong. 2d Sess. 83 (1992).

[44] Austin, Texas et al. at 5-7.

[45] Id. at 6.

NCTA in its initial comments explained that the Commission should not adopt a productivity offset to the GNP-PI. There is no economic basis for applying such an offset to the cable industry, and randomly selecting a measure from other contexts and imposing it on the cable industry would be entirely arbitrary and harm future growth.

Nonetheless, such an approach is precisely what Bell Atlantic proposes. It argues that "to avoid conferring an artificial competitive advantage on cable . . . the Commission must ensure that its price cap mechanism for cable operators parallels that for telcos."[46] The Commission rejected precisely this argument in its rate regulation reconsideration on the grounds that "telephone companies have failed to advance a sufficient reason why we should adopt as an overriding policy goal achieving parity in price cap mechanisms for the two industries."[47] The Commission there described that "our price caps requirements for cable and telephone services are, and should be, based on the respective, separate considerations discussed in the proceeding in which we adopted these respective requirements."[48] Nothing presented by the telephone companies here warrants a change in that view.

As described in our initial comments, there is no way to measure cable industry "productivity" at this point,[49] and there is reason to expect that the onset of regulation will

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[46] Bell Atlantic at 11.

[47] First Order on Reconsideration, MM Docket No. 92-266 (Aug. 27, 1993) at ¶ 90.

[48] Id.

[49] Even BellSouth concedes that "there is insufficient evidence in the record at this time to determine an appropriate productivity offset for the cable industry based on industry specific studies of the type used by the Commission in developing the price cap plan for the telecommunications industry." BellSouth at 34. Nevertheless, it suggests that the Commission "assume" similar productivity until such an analysis can be completed. Id. at 35.

make cable less, rather than more, efficient in the foreseeable future. Under these circumstances, adoption of a productivity offset will harm the industry, reduce quality improvements to the detriment of subscribers, and should not be imposed.

CONCLUSION

For the foregoing reasons, the Commission should adopt cost-of-service standards consistent with NCTA's initial comments and the comments presented herein.

Respectfully submitted,

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The Use of Competitive Market Value For Cable System Rate Base Valuation

I. Introduction

Valuing a regulated company's rate base, the assets on which it earns a return, by the original cost of tangible assets has serious deficiencies. This method, which is contemplated in ¶35 of the Notice of Proposed Rulemaking, ignores intangible assets. Intangible assets are long-lived legal rights and competitive advantages that are developed or acquired by a business.[1] Intangible assets include a large and vital part of any cable system's capital investment. Furthermore, original cost can seriously understate the value of tangible assets, which may have increased significantly since those assets were originally acquired.

An important goal of rate regulation is to protect consumers by promoting economic efficiency. Consumer economic welfare is enhanced when prices are "competitive"—as close as possible to the prices that would prevail if there were competition. If prices are too high, the quantity demanded is too low, and sellers earn monopoly rents. If prices are too low, the quantity supplied is too low, leading to shortages and underinvestment. Consumers have as much to lose from prices that are too low as they do from prices that are too high, as the federal government's experience with natural gas wellhead regulation amply demonstrates.[2]

The method of valuing the rate base should lead to prices that are as near to competitive prices as possible—neither too high nor too low. Original cost is the wrong answer to this question for cable television service.

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1 This definition is from Jan R. Williams and Martin A. Miller, *GAAP Guide 1993*, Harcourt, Brace, Jovanovich, New York, 1993, p. 21.01. Our previous paper, "Prices Above Book Values Do Not Imply Market Power," August 25, 1993, contains an extended discussion of the concept of intangible assets.

2 See, for example, MacAvoy, Paul and Robert Pindyck, *Price Controls and the Natural Gas Shortage*, (American Enterprise Institute 1975).